THE STOCK EXCHANGE BUSINESS A COURSE OF STUDY WITH REFERENCES

INVESTMENT BANKERS ASSOCIATION OF AMERICA AND ASSOCIATION OF STOCK EXCHANGE FIRMS

Thos Gagan

Nov 27/18

THE STOCK EXCHANGE BUSINESS

The Stock Exchange Business

A Course of Study with References

New York
Doubleday, Page & Company
for
Investment Bankers Association of America
and
Association of Stock Exchange Firms
1918

INVESTMENT BANKERS ASSOCIATION OF AMERICA

Education Committee

Lawrence Chamberlain, Chairman

E. W. Bulkley

Preparation of material by

S. S. Huebner, Ph. D.

Professor of Insurance and Commerce, Wharton School, University of Pennsylvania; Lecturer on Insurance at Columbia University; Lecturer on Stock Brokerage, New York University School of Commerce, Wall Street Division.

Full titles of books referred to will be found in the Bibliography at the end of the book.

DIVISION I
FUNCTIONS OF EXCHANGE MARKETS

TOPIC I

ECONOMIC FUNCTIONS OF ORGANIZED EXCHANGE MARKETS

Functions of a broad continuous market. Briefly outlined these services are:—

Huebner, 7, 8-9.
Van Antwerp, 17-23.
Emery, 156-58.

(1) Mobility given to property.

(2) Constitutes the chief reliance of creditors for prompt liquidation of collateral. Exchange quotations are used by banks everywhere as a basis for collateral loans. Exchange quotations also constitute evidence of value, the courts of justice measuring damages on the basis of these quotations.

(3) Constitutes the reliance of owners of securities for prompt conversion of their holdings into cash, thus enabling the prompt limiting of losses, if desirable.

(4) Makes the use of stop orders feasible.

(5) Makes possible the convenient transaction of business by odd-lot brokers for the best advantage of small investors.

(6) Gives constant quotations for the benefit of security owners and creditors.

(7) Furnishes a ready market for privileged subscriptions by making arbitraging in "rights" possible.

(8) Makes arbitraging between different markets, and all the advantages resulting from this practice, possible.

(9) Enables arbitraging in convertible securities.

Exchanges are clearing houses of current news.

Huebner, 8-9.
Van Antwerp, 41-42.
Emery, 101-103, 107-108, 115-118.

Quoted prices and actual values are harmonized, and defenseless security holders are protected against false or concealed news.

Van Antwerp, 4-16.

Values are standardized and the flow of capital is directed from unprofitable to profitable channels.

Huebner, 11-13.
Van Antwerp, 17-20, 26-32, 43.
Emery, 143-56.

Favorable influence exerted upon the money market.

Huebner, 17-18.

Exchange markets discount future business conditions.

Huebner, 13-17.
Van Antwerp, 22-24, 46-49.
Emery, 115-118.

Functions of short-selling. Briefly summarized these services are:—

Huebner, 15-17.
Van Antwerp, 71-95.

(1) Stabilizing effect upon the market.

(2) Discounting function.

(3) Resisting power to excessive inflation.

(4) Supporting power against unwarranted declines in the market.

(5) Sellers of securities, unable to deliver at once, may borrow for delivery purposes.

(6) Hedging dangerous market positions.

(7) Operations of odd-lot dealers made possible.

(8) Operations of specialists in the market made possible.

(9) Arbitraging between markets made possible.

(10) Arbitraging in rights.

(11) Enables selling of "rights" before new securities are issued.

(12) Enables arbitraging in convertible securities.

(13) Continuous character of the market greatly increased.

(With reference to this topic see Chapters on "Discounting Function of Exchange Markets" and "The Functions of Short-selling". Huebner: "The Stock Market".)

TOPIC II

REGULATION OF BROKERAGE TRANSACTIONS AND THE CONDUCT OF BROKERS

Economic service resulting from the safeguards which an organized exchange market gives in regulating brokerage transactions and maintaining a standard of commercial honor among brokers and dealers much higher than would otherwise exist.

Huebner, 9-11.

Regulation of the personnel constituting the market:

Obligation of members to abide by the constitution and all subsequent amendments thereto.

Constitution of the New York Stock Exchange, Article XIII, Section 5.

Admission requirements and method of reinstatement.

Constitution of the New York Stock Exchange, Article XV, Section 2. Article XVI, Sections 4, 5 & 6.

Regulation of partnerships and branch offices.

Constitution of the New York Stock Exchange, Article XXXV.

Prohibition of certain kinds of fraud or undesirable practices:

Fictitious transactions—"wash sales" and "matched orders."

Constitution of the New York Stock Exchange, pp. 50, 96.

"Bucketing" of orders.

Constitution of the New York Stock Exchange, p. 82.

Buying or selling by broker of the securities for which he has accepted an order, for his own account, for that of a partner, or for any account in which he has an interest.

Constitution of the New York Stock Exchange, p. 81.

Securities for which brokers have both orders to buy and sell must first be offered at one-eighth per cent higher than their bid before making transactions with themselves.

Constitution of the New York Stock Exchange, p. 78.

Improper use of a customer's securities by a member or his firm.

Constitution of the New York Stock Exchange, p. 97.

Brokers must keep complete accounts, subject at all times to examination by the proper committee, and which may not be destroyed or refused for submission.

Constitution of the New York Stock Exchange, pp. 31, 32

Publication of advertisements of other than a strictly legitimate business character forbidden.

Constitution of the New York Stock Exchange, p. 76

Acceptance or carrying of an account without proper or adequate margin.

Constitution of the New York Stock Exchange, p. 97.

Reckless or unbusinesslike dealing.

Constitution of the New York Stock Exchange, p. 97.

Adoption and significance of general rules which may be extended to cover every practice regarded

as contrary to just and equitable dealing. As events justify, various acts or omissions are from time to time declared to come within the scope of one or the other of the following:

Hearings on S. 3895, 63d Congress, Second Session, 723-30.

Expulsion when members are adjudged "guilty of fraud or of fraudulent acts".

Constitution of the New York Stock Exchange, Article XVII, Section 2.

Suspension or expulsion for "conduct or proceedings inconsistent with just and equitable principles of trade".

Constitution of the New York Stock Exchange, Article XVII, Section 6.

Suspension for acts "which may be determined by the Governing Committee of the Exchange to be detrimental to the interest or welfare of the exchange".

Constitution of the New York Stock Exchange, Article XVII, Section 8.

Establishment of a Committee on Business Conduct charged with the duty of "considering matters relating to the business conduct of members with respect to customers' accounts,"

and of keeping "in touch with the course of prices of securities listed on the exchange, with a view to determining when improper transactions are being resorted to."

Constitution of the New York Stock Exchange, Article XI, Section 4.

Regulation of brokerage transactions as regards:

Acceptance of smaller offerings when offering to buy or sell more than one hundred shares.

Constitution of the New York Stock Exchange, pp. 78-81.

Arbitration of disputes arising between members, and if non-members are willing, between members and their customers.

Constitution of the New York Stock Exchange, Article XI, Section 3.

Regulation of bids and offers.

Constitution of the New York Stock Exchange, Article XXIII.

Comparison of orders and liability on contracts.

Constitution of the New York Stock Exchange, Article XXIV.

Payment for and delivery of securities—settlement of contracts.

Constitution of the New York Stock Exchange, Articles XXV, XXVI, & XXVII.

Closing of contracts "under the rule".

Constitution of the New York Stock Exchange, Article XXVIII.

Deposits on contracts.

Constitution of the New York Stock Exchange, Article XXXI.

Dividends, interest, or premiums.

Constitution of the New York Stock Exchange, Article XXXII.

Transfer and registry.

Constitution of the New York Stock Exchange, Article XXXIII.

Commissions to be charged.

Constitution of the New York Stock Exchange, Article XXXIV, and pp. 86, 87.

Suspension and re-instatement of insolvent members.

Constitution of the New York Stock Exchange, Article XVI.

TOPIC III

NATURE AND FUNCTIONS OF OPTIONS

A knowledge of the nature and uses of "options" or "privileges" is necessary to a full understanding of the functions of organized exchange markets. Too frequently such contracts are used for unnecessary, or even illegitimate purposes. Yet such misuse of options should not cause us to overlook their true economic and insurance functions. While not recognized by the New York Stock Exchange, unlike the London and Paris Exchanges, stock exchange firms may deal in privileges, and some have from time to time issued special circulars describing their nature and functions.

(In addition to the following bibliography, reference should be made to Leonard R. Higgin's work on "The Put-and-Call", London, Effingham Wilson, Royal Exchange, 1906. This book treats of the London practice pertaining to options, is highly scientific in its nature, and is devoted largely to a discussion of the mathematical phases of the subject.)

Definition of various kinds of options, and contract forms used. *Nelson, 10-13, 18-21, 45-48.*

Status on the New York Stock Exchange.

Constitution of the New York Stock Exchange, Article XXIII, Sec. 9.

American and London Options contrasted

Huebner (Chapter on "Privileges and their Functions" in "The Stock Market").

Services rendered by:

Limiting losses on market commitments while leaving open the possibility of increased profits.

Insuring accumulated profits.

Insuring dealers who make numerous trades and wish frequently to change their position in the market.

Huebner (Chapter on Privileges and Their Functions, "The Stock Market").

Unnecessary or illegitimate uses of privileges:

Operating in stocks without actually buying or selling the same.

Misleading market opinion by manipulators attempting to accumulate or distribute certain lines of stocks.

Facilitating the operation of a corner.

Trading in options themselves.

Facilitating advertising and selling campaigns.

Betting purposes.

Nelson, 22-29.
Huebner (Chapter on Privileges and Their Functions, "The Stock Market").

Considerations determining the value of options.

Nelson, 14-17, 30-43.

Legal principles governing.

Dos Passos, I, 404-406, 601-14.

Question 1. Define: "call", "put", "straddle", or "spread".

Question 2. If, after the option has been sold, the seller feels that he ought to protect himself, show fully how the seller of the option may limit his risk.

Question 3. Explain all the differences between London and American options. In this connection explain the application of the interest allowance in the case of London options.

Question 4. What are the considerations which suggest the figure, let us say of 5¼, as a safe premium for the risk incurred in selling a "put" or "call" on Union Pacific for a period of three months? Why should the quotation for the same stock be higher if the period covered is greater?

Question 5. Explain the several ways in which options may serve the purpose of insurance.

Question 6. What is the legal status of options, and explain the reasoning of the courts.

TOPIC IV

NATURE AND FUNCTIONS OF ARBITRAGING

Description of New York-London arbitraging.

Nelson, 51-59.

Stock Exchange Regulations concerning.

Constitution of the New York Stock Exchange, 76-78.

How shipment of securities is avoided.

Nelson, 54-55.
Huebner, 20.

Method of, and expenses connected with the shipment of stocks between London and New York.

Nelson, 67-72.

Conversion of London into New York prices.

Nelson, 78-87.

Services rendered by:

Facilitates the cancellation of international debts.

Brings prices of securities to a common level in all the leading stock markets of the world.

Huebner, 19-20.

Arbitraging in privileged subscriptions or "rights"

(Also see Topic XVI.)

Nelson, 60-63.

Question 1. A certain stock was purchased in London at 245 and shipped to New York. Ascertain the cost of the stock in New York, assuming the cost of a cable transfer to be $4.87. Explain how the arbitrageur manages to eliminate as much as possible the shipment of securities from one market to the other.

Question 2. With exchange at $4.86½, convert a London price of 186 into its New York equivalent, and explain the reason why you follow the method used.

Question 3. The Canadian Pacific Railroad Company issued new stock to its stockholders at $150 a share to the extent of ten per cent of their holdings. With the old stock quoted at $240 a share, the mathematical value of the "rights" would be 8¼. Explain fully how an arbitrageur would effect an arbitrage transaction between the "rights" and the stock.

DIVISION II

ORGANIZATION AND OPERATION OF THE MARKET

TOPIC V

LEGAL STATUS AND ORGANIZATION OF STOCK EXCHANGES

The general legal nature of stock exchanges. Unlike produce exchanges, American stock exchanges are private, voluntary, unincorporated associations.

Dos Passos I, 13-28.
Emery, 13-17.

Stock exchanges are unlike partnerships, corporations or incorporated joint-stock associations.

Dos Passos I, 28-32.

Members' rights in the property holdings of non-incorporated stock exchanges.

Dos Passos I, 32-40.

Law governing suits against stock exchanges.

Dos Passos I, 40-56.

Legal interpretation of the powers of exchanges to suspend and expel members.

Dos Passos I, 72-112.

Property rights of stock exchanges in quotations, representing their floor transactions, and their right to control the publication and distribution of the same.

Dos Passos I, 22-28.
Commercial Telegram Co. vs. Smith, 47 Hun. 494.

Legal nature of a stock exchange seat.

Dos Passos I, 144-164.
Emery, 22.

Preferred rights of exchange members to the proceeds of defaulting members' seats.

Several times provisions in the constitution of a stock exchange providing for the distribution of the proceeds of a seat in a definite order of priority, favorable to members as compared with outside creditors, have been upheld by the courts.

Constitution of the New York Stock Exchange, Article XV, Sec. 3.
Dos Passos I, 113-28.
Hyde vs. Wood, 94 U. S. 523.

The government of stock exchanges—powers and duties of various officers and standing committees, and qualifications for admission to membership.

Constitution of the New York Stock Exchange, Articles II to XIII, inclusive.

Comparison of American stock exchanges with leading foreign exchanges.

Emery, Chapter 2, Part I.
Van Antwerp, Chapters IX & X.
Vidal, "History and Methods of the Paris Bourse".
Koch, "German Stock Exchange Regulation".

TOPIC VI

CLASSIFICATION AND DESCRIPTION OF VARIOUS CLASSES OF STOCKS

Nature of stocks as contrasted with bonds.

Chamberlain, 29-37, 488-90.

Classification with reference to par value.

Adams, 43-45.
Lyon I, 84.

Classification with reference to issue:

Authorized and unissued stock.

Adams, 45.
Lyon I, 109.

Treasury Stock.

Adams, 45-46.
Lyon II, 9-12.

Assessable stock.

Adams, 46.

Common stock and the rights pertaining thereto.

Adams, 46-48.

Preferred stock classified according to:

Dividends—"cumulative" or "non-cumulative"; special dividend funds; first, second, etc., preferred stock.

Adams, 49-50, 52-53.

Assets on dissolution of the corporation.

Adams, 50-51.

Voting power—exclusive or special.

Adams, 51-52.
Lyon I, 22-28.

Callable feature.

Adams, 53-55.
Lyon I, 25-28.

Convertible feature.

Adams, 55-56, 57-58.
Lyon I, 20-21.

Participation in earnings over and above stipulated dividend.

Adams, 56-57.
Lyon I, 17-20.

Deferred Stock.

Adams, 48-49.

Guaranteed stock and various conditions of the guarantee.

Adams, 59-60.

Debenture stock.

Adams, 61.

TOPIC VII

QUOTATION SERVICE OF EXCHANGES

Manner of collecting and disseminating quotations. *Pratt, 182-83.*

Nature and interpretation of the abbreviations used in recording quotations on the tape.
Pratt, 184-88.

The ticker as a timekeeper for the street.
Pratt, 188.

Exchange safeguards preventing misuse of the ticker service. *Pratt, 183, 189.*

Non-official character of quotations recorded by the stock exchange. *Pratt, 189.*

The right of stock exchanges to own and to control the publication and distribution of quotations representing their floor transactions.
Dos Passos I, 22-28.
Commercial Telegram Co. vs. Smith, 47 Hun. 494.

Importance to the market of other methods of wire communication and of news agencies.
Pratt, 189-97.

TOPIC VIII

LISTING OF SECURITIES

It is one of the primary purposes of the stock exchange to see that the interests of the public are properly safeguarded as regards the issuance and marketing of securities. To this end listing of securities constitutes one of the essential elements of an organized security market. By this practice corporations, before their stocks or bonds can be dealt in on the floor of an exchange, must comply with certain standards of legality, security and workmanship.

Stock exchange regulations concerning the Stock List Committee and its powers and duties.

Constitution of the New York Stock Exchange, Article XI, Section 12; Article XXXIII, Sections 2, 3 & 4.

Listing is not a guarantee of value and does not imply the Exchange's recommendation of the security for favorable consideration by investors and speculators.

Pratt, 125-27.
Chamberlain, 62-63.

Listing requirements of the New York Stock Exchange concerning:

Organization of the corporation and the nature of its securities.

Hearings on S. 3895, 63d Cong., Second Session, 739-41.

Description of the property.

Hearings on S. 3895, 739-41.

Engraving of certificates.

Hearings on S. 3895, 744-45.

Regulation of the printed text of certificates.

Hearings on S. 3895, 739-40.

Transfer and Registry.

Hearings on S. 3895, 744.

Papers to be filed with the application for listing.

Hearings on S. 3895, 742.

Agreements with the Exchange which corporations must observe.

Hearings on S. 3895, 742-43.
Pratt, 130-31.

Listing of securities of reorganized corporations.

Hearings on S. 3895, 741.

Listing of additional amounts of securities already listed.

Hearings on S. 3895, 742.

Suspension or removal of securities from the list.

Hearings on S. 3895, 210-16, 743.

The process of listing explained.

Hearings on S. 3895, 199-200, 205.

Advantages of listing:

Reasonable assurance of legality of issue, proper text of the security, and safeguards against counterfeiting.

Hearings on S. 3895, 203-04.

Greater publicity to the public.

Hearings on S. 3895, 201-02.
Pratt, 127-28.

Greater convertibility.

Chamberlain, 63-64.

Greater hypothecary value.

Chamberlain, 65-66.

Corporations must observe certain agreements with the Stock Exchange.

Hearings on S. 3895, 742-43.
Pratt, 130-31.

Advertises and popularizes the stock.

Hearings on S. 3895, 206.

Traders protected against a too restricted volume of outstanding stock.

Van Antwerp, 167-68.

London Exchange, without further examination, lists any security listed on the New York Exchange.

Hearings on S. 3895, 202.

(With reference to this Topic also see Chapter on "Listing of Securities", Huebner: "The Stock Market".)

TOPIC IX

CLASSES OF DEALERS AND BROKERS COMPOSING THE MARKET

Commission Brokers.

Van Antwerp, 278.

"Floor" or "room" traders.

Van Antwerp, 284-85.

Odd-lot dealers.

Van Antwerp, 281-82.
Hearings on S. 3895, 63d Congress, Second Session, 160-178.

Specialists.

Van Antwerp, 278-80, 283.

Arbitrageurs.

Van Antwerp, 283-84.

"Floor" or "Two-dollar" brokers.

Van Antwerp, 280-81.

American system compared with the "jobbing" system of London.

Van Antwerp, 277-78, 335-42, 372-74.
Withers, Chapters VIII and IX.

(With reference to this topic also see Chapter on "Types of Dealers and Brokers and their Work". Huebner: "The Stock Market".)

TOPIC X

TYPES OF OFFERS AND ORDERS AND THEIR INTERPRETATION

General rules and customs of the Stock Exchange governing the purchase and sale of securities.

Norton, 25.

Offers classified according to time of delivery:

"Cash".

"Regular Way".

"At three (or two) days".

"Delivery postponed longer than three days and not longer than sixty days".

"Delivery fixed by happening of some future event".

Article XXIII, New York Stock Exchange Constitution.
Article XXVI, Section I, New York Stock Exchange Constitution.
Norton, 25-27.
Dos Passos I, 183-85.

Other Exchange regulations concerning bids and offers.

New York Stock Exchange Constitution, pp. *78-81.*

Contracts are not actual purchases and sales, but contracts to make purchases and sales.

Norton, 27-28, 31, 40.

Manner of completing a purchase or sale for the "investment account".

Norton, 28-30.

Manner and legal effect of "taking" the order.

Norton, 34-36.

Legal principles relating to the carrying out of the order.

Norton, 36-38.

A typical order analyzed (according to law and Exchange usage) as to the meaning of:

Technical words and abbreviations.

Norton, 31.
Dos Passos I, 206.

"Buy" or "sell".

Norton, 31.

"For me" or "for my account".

Norton, 31.

"At my risk".

Norton, 31.

Time of delivery when not specified.

Norton, 31.

Number of shares broker may buy.

Norton, 32.
Dos Passos I, 208-09.

Price when stipulated; or when not stipulated in the order.

Norton, 32.
Dos Passos I, 207.

Duration and cancellation.

Norton, 38.
Dos Passos I, 210.

Actual and prompt execution.

Norton, 38.
Dos Passos I, 206-07.

Right to execute anywhere, if not limited.

Dos Passos I, 209.

Discretionary orders.

Dos Passos I, 211-12.

The Commission charged.

Constitution of the New York Stock Exchange, Article XXXIV, and page 86.
Norton, 39.

Notice to customer, and legal principles concerning.

Norton, 39.
Dos Passos I, 212-13.

Stop orders.

Dos Passos I, 302-06.

(With reference to the aforementioned subject matter see Chapter on "Types of Offers and Orders" in Huebner: "The Stock Market".)

Question 1. Define fully each of the several types of offers to buy or sell, with reference to the time of delivery. As regards each definition, include the particular time of delivery specified by the Rules of the New York Stock Exchange.

Question 2. Explain the legal nature of the contract (execution of an order) made on the floor of a stock exchange.

Question 3. Compare the "stop order" with "options" as a means of limiting losses. This question involves a statement of the comparative advantages and disadvantages. (Also see Topic III.)

Question 4. A customer gives his broker the following order: "Buy for my account and risk 300 A. R. at 77. This order to remain in force until cancelled". Rewrite this order so as to fully express the meaning in accordance with the law and the usages of the Stock Exchange.

Question 5. Explain fully the obligations of a broker in relation to the execution of the above mentioned order.

Question 6. Explain fully the obligations of the customer to the broker in relation to the execution of the above mentioned order.

Question 7. In connection with the execution of the above mentioned order, what implied rights (what authority) does the customer confer upon the broker?

TOPIC XI

ANALYSIS OF A MARGIN TRANSACTION

For an understanding of this topic the reader is referred to the majority and dissenting opinions in *Markham vs. Jaudon, 41 N. Y. 235.* The case is worthy of careful study, since it covers the topic and constitutes a text of the subject matter. The dissenting opinions in the case are also instructive, being fully reported "at the request of many leading members of the profession", because, as the court report states: "numerous contracts are daily made in the City of New York, frequently involving enormous amounts, and also because of the fact that this is the first full consideration in the court of last resort, of the legal relation of the parties in such contracts".

Respective rights and obligations of broker and customer in a speculative transaction.

Markham vs. Jaudon, 41 N. Y. 239-40.

Concerning the execution of the order, the legal position of the broker is that of an agent.

Markham vs. Jaudon, 240.

The broker, when holding securities for a customer which are only partially paid for, is subject to the law of pledgor and pledgee. Hence before selling these securities, the pledgee must give reasonable notice of the time and place of sale, and the sale must be effected at a place of "public sale".

Markham vs. Jaudon, 240-45.

Stock exchanges are commonly held by the courts to be places of "private sale" since they are essentially private, no one being allowed to enter the room but members.

Dos Passos I, 357-65.

Where, however, a customer is "short" of stock and the broker is obliged to close the transaction by buying in the stock, it is necessary to construe a stock exchange to be a place of public sale, although no special clause to this effect may have been inserted in the broker's order.

Dos Passos I, 357.

The legal effect of the above principles, which would tend to render the carrying of speculative accounts impracticable, may be overcome by having the order provide words to the effect that the broker "may, at any public or private sale, sell without notice, and may buy in, at any public or stock board sale, all stock purchased for me (the customer) when all your liability for, and all indebtedness to

you of the undersigned shall not be satisfactorily secured; it being understood that you (the broker) reserve the right to determine such security".

Markham vs. Jaudon, 244, 248-50.

The customer's right to control and take up the stock purchased on margin.

Dos Passos I, 275-83.

The form and manner of serving notice for additional margin.

Dos Passos I, 336-46.

The measure of damages in case of wrongful conversion by a broker.

In *Markham vs. Jaudon* the amount of damage was measured by "the highest market price of the property between the time of the wrongful conversion and the trial". But it was soon seen that the application of this rule would work great hardship in many cases, and consequently a different ruling was adopted as in the cases of *Baker vs. Drake, 53 N. Y. 211,* and *Gallagher vs. Jones, 129 U. S. 193.* In these cases the true measure of damages in stock transactions was declared to be "the highest intermediate value reached by the stock between the time of the wrongful act complained of and a reasonable time thereafter, to be allowed to the party injured to place himself in the position he would have been in had not his rights been violated". What constitutes rea-

sonable time depends upon the circumstances of each case.

Markham vs. Jaudon, 245, 251-52.

Question 1. In the case of a margin transaction to what extent is a broker an agent and to what extent is he a pledgee?

Question 2. Give the reasons which caused the New York Court to apply the law of pledgor and pledgee to the brokerage business in speculative transactions. Analyze the order to buy or sell with special reference to the various clauses which are inserted for the broker's protection, and in connection with each explain the reason for incorporating the same.

TOPIC XII

THE SHORT SALE

Definition and General Nature of Short Selling.

Norton, 5-8.

Nature of the loan of securities necessary to conduct a short sale:

Brokers deal together as principals.

Norton, 8-9.

Call loan for both borrower and lender.

Norton, 9.

Complete title to stock lent transferred to borrower.

Norton, 9.

Market price (plus a margin at times) deposited by the borrower with the lender.

Norton, 9-11.

Borrower liable for dividends or accretions to the lender; and lender liable for assessments to the borrower.

Norton, 10-11.

Interest payment by lender to borrower, and factors determining this interest rate.

Norton, 11-12.

Termination of the loan transaction.

Norton, 12-13, 41-48.

Limitations upon broker's authority to borrow.

Norton, 31-32.

Maintenance of the loan.

Norton, 32-34.

The order to sell short interpreted according to law and Stock Exchange usage.

Norton, 13-28.
Dos Passos I, 323-34.

Customer's margin protecting the broker.

Norton, 35-41.

Economic services rendered by short selling in the security market:

Discounting function of the market facilitated.
Steadies prices at all times.
Resists excessive inflation and checks unwarranted declines.
Owners of securities, unable to deliver at once, may nevertheless sell and borrow for purposes of delivery.
Makes possible the hedging of a dangerous market position.

Operations of "odd-lot dealers" greatly facilitated.

Operations of "Specialists" greatly facilitated.

Arbitraging between different markets made possible.

Arbitraging in "rights" made possible.

Owners of "rights" may dispose of same by selling short an equal amount of old stock.

Arbitraging in convertible securities made possible.

Continuous character of the security market greatly increased.

Huebner, 15-17.
Van Antwerp, 78-82, 420-21.

(With reference to this topic, also see Chapter on "The Short Sale" in Huebner: "The Stock Market".)

Question 1. On March 1, a customer orders his broker "X" to sell short for him on the New York Exchange, regular way, 100 shares of a certain stock at $75 (par value of shares $100), and the order is executed at this figure. The customer agrees to protect the broker with the customary margin of 10%, and agrees to keep this margin good.

The broker borrows the shares from another broker "A," but on March 8 "A" wants to discontinue the loan. During the week of March 1 to March 8, call money

in New York rules at 3½%; the stock also rises gradually to 86.

On March 8, "X" borrows the stock from broker "B". On March 9 call money rises to 5%, and on March 10 to 6%, but on March 11 reacts to 4%. On March 11 the stock sells ex-dividend $1 a share. The stock in the meantime has declined to 80.

On March 14 "B" asks for the return of the securities and "X" enters into a loan transaction with broker "C". Call money is still ruling at 4%. On March 15 an assessment of $10 per share becomes due (the stock not having been fully paid).

On March 21 the stock has declined to 78, and the broker closes the transaction for his customer at this price, the customer having given an order to this effect.

On the basis of the above facts, explain *fully* the manner of operating this short sale from beginning to end, that is to say from the time the customer gives the order to sell to the rendering of the account to the customer by the broker. In your explanation, keep in mind the following features, and as regards each give the reason for the practice that prevails:—

(1) Nature of the order so far as the short selling feature is concerned.

(2) The margin of the customer.

(3) The delivery of securities to the buyer.

(4) The terms of the loan of securities.

(5) The assignment of the stock in the loan transaction.

(6) The factors of interest, dividends and assessments.

(7) The factors that enter into the account rendered by the broker to the customer.

TOPIC XIII

THE STOCK EXCHANGE CLEARING HOUSE SYSTEM

Process of clearing stocks explained:

Comparison of transactions.

Pratt, 171-73.
Todman, 69-70.

Nature and use of "clearance sheet".

Pratt, 173-76.
Todman, 70-72.

Use of "settlement price" for delivery or receipt of balances.

Pratt, 168-69, 173, 177.
Todman, 72-74.

Use of check or draft in settling cash balances.

Pratt, 175, 176.

Statements for delivery or receipt of balances.

Pratt, 176.
Todman, 74-75.

Use of "allotment sheets".

Pratt, 176.

Delivery of balances.

Pratt, 176.

Stock Exchange regulations concerning clearing:

Committee on Clearing House and its powers.

Constitution of the New York Stock Exchange, Article XI, Sec. 5; Article XXVII.

Securities to be cleared.

Constitution of the New York Stock Exchange, Article XXVII, Section 3.

Comparison of transactions.

Constitution of the New York Stock Exchange, Article XXIV.

Services rendered by the Stock Exchange Clearing House:

Certification of checks greatly reduced.

Pratt, 165-67.

Actual deliveries of shares greatly reduced.

Pratt, 167.

Volume of checks greatly reduced.

Pratt, 164.

Confusion and risk involved in actual deliveries eliminated.

Pratt, 165.

Loss and time involved in insolvencies greatly reduced.

Pratt, 177.

Numerous transfers of shares avoided.

Van Antwerp, 120.

Desire for, and method of, securing secrecy.

Pratt, 179-180.

Legal principles underlying clearing house systems.

Dos Passos I, 406-09.
Pratt, 165.

New York System contrasted with the London Fortnightly Settlement System.

Withers, Chapter IX.
Van Antwerp, 365-66, 373-76.

(With reference to this Topic see Chapter on "Stock Exchange Clearing Houses," Huebner: "The Stock Market".)

Question 1. On a given day broker "X" of the New York Stock Exchange buys the following stocks: From broker "A" 200 shares of American Smelting and Refining at 69; from broker "B" 200 New York Central at 70; from broker "C" 300 U. S. Steel common at 91; from broker "D" 300 Union Pacific at 121; and from broker "E" 200 Southern Pacific at 90.

On the same day broker "X" sells the following stocks: To broker "F" 200 American Smelting and Refining at 67; to broker "G" 100 New York Central at 72; to broker "H" 200 U. S. Steel at 92.

The closing quotations for the day are: American Smelting and Refining 71¼, New York Central 71, U. S. Steel common 90¾; Union Pacific 118, and Southern Pacific 88.

Prepare broker "X's" clearance sheet, which is to be submitted to the Clearing House. Prove that in the above illustration broker "X" did not lose or gain through the operation of the clearing house system.

Question 2. Explain the complete process of clearing the above mentioned business, including the discussion of clearance tickets and allotment sheets.

Question 3. Suppose that, in addition to the business referred to under Question 1, broker "X" had borrowed from broker "I" 100 shares of U. S. Steel common and loaned to broker "J" 100 Union Pacific. Show how broker "X" would clear these loan transactions, and why this method is adopted. Explain the advantages resulting to the business community from the existence of a stock exchange clearing house and illustrate each advantage with the data furnished in Question 1.

TOPIC XIV

ASSIGNMENT AND TRANSFER OF SECURITIES

Stock Exchange rules designed to secure uniformity of action and to eliminate unnecessary risk, as illustrated by the New York Stock Exchange:

Constitution of the New York Stock Exchange, Article XXV, Section 2; Article XXXII; and Article XXXIII, Section 1.
Hearings on S. 3895, 63d Congress, 2d Session, 744-45.

(1) Corporations are required to maintain a transfer agency and registry office in the Borough of Manhattan, and both transfer agent and registrar must be acceptable to the Committee on Stock List. The registrar appointed must file with the secretary of the exchange an agreement to comply with the requirements of the exchange in regard to registration.

(2) The entire issue of capital stock must be transferable at the office at New York. If

transfers are made in other cities, certificates issued in such cities must be interchangeable and identical in color and form. No change in the form of certificate, the transfer agent, the registrar or the trustee of bonds can be made without the approval of the Committee on Stock List.

(3) Thirty days' notice must be given to the Exchange before a corporation increases its authorized capital stock.

(4) To prevent counterfeiting, all bonds, coupons, or certificates of stock must be made in accordance with the regulations of the Exchange.

(5) As regards the distinguishing features of various classes of securities, each denomination must be of such distinctive appearance and color as to make them readily distinguishable from other denominations.

(6) The purchaser is given the option to require delivery to be either in certificates or by transfer. In case, however, personal liability attaches to ownership, the seller is given the right to deliver by transfer. When the transfer books are closed, the buyer cannot require delivery by transfer

(7) The blank form of assignment and power-of-attorney is prescribed by the exchange; and to constitute a good delivery, the assignment must conform with the rules of the Exchange.

Negotiable securities dealt in on exchanges.

Dos Passos I, 648-56.

Necessary elements of negotiability.

Dos Passos I, 675-78.

Negotiability of stock certificates.

Dos Passos I, 700-725.

Analysis of the blank form of assignment and power-of-attorney.

Leading principles to be observed in connection with the assignment, transfer and registration of various classes of securities.

Process of transferring stock explained.

Significance attaching to the guarantee of signatures by brokers.

Method of effecting transfer of stock by corporations.

Replacement of new for lost certificates.

(With reference to the last six sub-heads of this topic see Chapter on "The Transfer of Securities", Huebner: "The Stock Market".)

TOPIC XV

CONVERSION OF SECURITIES

At a recent date total outstanding issues of listed convertible securities, exclusive of domestic and foreign convertible government bond issues, amounted to over $1,500,000,000. Of this total approximately 80% consisted of bonds convertible into stock, and most of the balance of stocks convertible into other stocks. When major price movements occur in the market the conversion privilege often assumes an important place in the work of certain classes of dealers in the security market.

Meaning of the conversion privilege.

Rollins, 97-98 (In Volume on "Stocks and the Stock Market".)

Various conditions governing the conversion privilege, and the motives prompting their adoption.

Rollins, 98-101, 102-03, 106-07, 108-10.

Price movement of convertible securities in relation to one another, and reason therefor.

Rollins, 103.

Effect which the conversion privilege sometimes has upon the market value of the stock.

Rollins, 101-102.

Method of reducing current quotations of bonds and stocks, into which they are convertible, to a common basis.

Rollins, 4, 6-7 (In Volume on "Convertible Securities".)

Accumulation dividend tables and their use.

Rollins, 18-19.

Conversion tables and their use.

Rollins, 6-7, 18-19.

Method of adjusting fractional shares which cannot be converted evenly.

Rollins, 108-09.
Rollins, 8-10.

Price relationship between convertible issues where the conversion privilege becomes effective at some future time.

Rollins, 104-106.
Rollins, 14-16.

Method of treating accrued interest and dividends when a conversion is made.

Rollins, 107-108.

Arbitraging in convertibles explained.

Rollins, 18-19.

Question 1. What effect has the existence of a convertible bond issue upon the price of the stock into which the bond may be converted?

Question 2. Suppose a $1000 bond is convertible into stock at 130. Explain (mathematically) the several methods of adjusting the fractional shares. Which method of adjustment do you regard as the most desirable, and why?

Question 3. What considerations would you take into account in deciding between the desirability of purchasing the convertible bond or the stock at prevailing quotations, where the right to exchange the bond into a stock becomes operative, say, 10 years from date? Assume that the current quotations clearly reflect a conversion value in the bond over and above a mere investment worth.

Question 4. Union Pacific 4% convertible bonds, due in 1927, are convertible at par into common stock at 175. State all the circumstances under which it will prove profitable to exercise the conversion privilege.

Assume Union Pacific stock to be quoted on April 8 at 155½, and that the preceding dividend date was April 1. Taking the bond referred to in the above paragraph, show the manner of computing the conversion equivalent of the bond.

With the bond quoted at 102.93, show the manner of computing the stock equivalent.

Question 5. Suppose that on April 8, with the stock selling at 155½, the bond was selling at ½ below its conversion equivalent. Show (mathematically) how an arbitrage transaction between the two securities is consummated. Need an arbitrageur actually effect a conversion?

TOPIC XVI

MARKETING OF PRIVILEGED SUBSCRIPTIONS, OR "RIGHTS"

Meaning of "rights" on different Stock Exchanges.

Burgunder, 74.
Mitchell, 241-42.

Extent to which rights have been issued by leading American corporations.

Burgunder, 73-74, 78, 87-96.

Determination of the mathematical value of rights.

Burgunder, 76-77.
Lyon II, 23-24.

Meaning of "rights on" and "ex-rights" explained.

Burgunder, 74.
Lyon II, 27.

Stock Exchange regulations concerning "ex-rights" and commissions.

Constitution of the New York Stock Exchange, Article XXXII, Sec. 2; XXXIV, Sec. 2. (c).

Plans of issuance followed by various corporations.

Burgunder, 74-75, 85.
Mitchell, 239-40.

Methods which stockholders may employ in disposing of their rights, and the respective advantages and disadvantages of each method.

(In addition to the following methods it may be added that rights are nearly always discounted in the market. Accordingly the stockholder may, if he is willing to part with his original investment, sell the same when the rights are announced, the price including the value of the right):

May sell his rights since a market for them is made as soon as the corporation announces the allotment.

Mitchell, 240-42, 243-44.
Lyon II, 24.

May sell an amount of his original holdings equal to the number of new shares to which he is entitled, replacing the shares sold with the new stock when issued.

Mitchell, 238-40, 243-44.

May subscribe to his allotment of new shares, selling the same when issued by the corporation.

Mitchell, 236.

May sell "short" an amount of stock equal to the allotment, borrow to fulfil delivery on

the short sale, and return the stock borrowed when the new shares are issued.

Mitchell, 236-38.

Extent and method of arriving at the profit where successive offerings of stock have been taken and added to the original holdings.

Burgunder, 75-76, 77-85, 87-96.
Mitchell, 245-58.

Arbitraging in rights.

Burgunder, 77.
Lyon II, 27-29.
Nelson, 60-63.

(With reference to this Topic see Chapter on "Privileged Subscriptions", Huebner: "The Stock Market".)

Question 1. Discuss the various methods which a stockholder may adopt in disposing of his rights, explaining in connection with each:

(1) the procedure followed.

(2) the advantages of the plan.

(3) the disadvantages of the plan.

(4) The relative value of the plan judged from the standpoint of financial return to the stockholder.

Question 2. The Penna. R. R. Co. gave its stockholders the privilege of subscribing to new stock at par ($50) to the extent of

10% of their holdings. At the time of the announcement of the privilege, the stock sold at 57¾. Explain the mathematical computation of the value of the right in New York. What would be the equivalent quotation for this right in the Philadelphia market? Explain the reasons for the difference in the quotation prevailing in the two markets.

Question 3. With Penna R. R. stock selling at 57¾, explain mathematically the procedure by which an arbitrageur effects a profitable arbitrage transaction between the "stock" and the "rights", and outline the services which such an arbitrageur renders. Also explain the considerations which the purchaser of rights should take into account in determining the market price that may be paid for rights.

TOPIC XVII

CURB AND AUCTION MARKETS

Relation of the New York Stock Exchange to the New York Curb Market.

Van Antwerp, 431, 433.
Huebner, 21-23.
Pratt, 199-200.
Constitution of the New York Curb Market, 11.
New York Curb Market Manual, 15.

Functions of the Curb Market.

Van Antwerp, 432, 433.
Pratt, 199-200.

Organization of the New York Curb Market.

Constitution of the New York Curb Market.
Pratt, 200-201.

Disciplinary control over members.

Constitution of the New York Curb Market, 11.

Types of orders and contracts.

New York Curb Market Manual, 16-18.

Regulations concerning deliveries.

New York Curb Market Manual, 18-21.

Comparison of transactions.

New York Curb Market Manual, 22-25.

Listing requirements.

New York Curb Market Manual, 25-27.

Transfer of curb securities.

New York Curb Market Manual, 28-32.

Commissions charged.

New York Curb Market Manual, 38.

Security Auction markets.

Huebner: Chapter on "Curb and Auction Markets" in "The Stock Market".

DIVISION III

FACTORS AFFECTING SECURITY PRICES AND VALUES

TOPIC XVIII

FACTORS AFFECTING THE PRICES AND VALUE OF SECURITIES

INTRINSIC EARNING POWER

Distinction between market prices and intrinsic values.

Pratt, 92-97, 98.

Stock markets are essentially markets for "incomes", i.e., in the long run prices are controlled by values. The general trend of prices is governed primarily by prospective fundamental values. In the long run, despite the ceaseless backing and filling of price movements, "prices" and "values" tend approximately to coincide.

Pratt, 96-103.

Comparative and fundamental statistics contrasted.

The physical condition and the earning power of a corporation are indicated by the reports of the corporations under consideration. The data contained in these reports should be classified as "comparative statistics". These

statistics relate to the present and past record of individual properties, and guide the investor or speculator in determining the approximate safety of an investment, or in the making of a selection between several investments. They should be distinguished from so-called "fundamental statistics" which refer to the present and prospective business situation in general, as reflected by certain well-known barometers, which, while showing the trend of the present, serve principally as a guide for the future.

Babson, Chapter I, 13-29.
Melvin T. Copeland, Statistical Indices of Business Conditions, pp. 1-41.
Quarterly Journal of Economics, Vol. XXIX, May, 1915.

Analysis of comparative statistics.

The value of both bonds and stocks, although representing entirely distinct classes of equities, must be ascertained along much the same methods of analysis. The important question is that of permanency, or "the result of the decade" which averages a showing for both poor and prosperous years. A good report contains detailed information along three distinct lines, viz., the physical characteristics, an income account, and a balance sheet dealing with financial characteristics. Each part is essential and all bear an intimate relationship

to one another. In analyzing these three parts, it is essential (1) not to judge a property on the basis of one year's showing, and (2) to bear in mind that, since all things are relative, comparisons must be made on the basis of certain fixed standards.

Moody, "How to Analyze Railroad Reports".

TOPIC XIX

FACTORS AFFECTING THE PRICE AND VALUE OF SECURITIES (CONT.)

THE MONEY MARKET IN ITS RELATION TO SECURITY PRICES

Relations between the stock and money markets:

Various uses which stock brokers, syndicates, investment houses and banks make of securities in the credit market.

Pratt, 266-67, 289-90.

Manner of financing margin transactions.

Pratt, 267-68.

Overcertification of broker's checks.

Pratt, 268-73.
Van Antwerp, 113-14.

Nature and method of handling broker's call loans.

Pratt, 273-89.

Explanation of the New York Clearing House Bank Statement.

Huebner: Chapter on "Relation of the Stock Market and the Money Market" in "The Stock Market".

Value of the New York Bank Statement as a barometer of credit conditions.

Babson, 297-98.
Huebner: (above chapter).

Significance of the "loan", "cash", "deposit" and "surplus reserve" items of the Bank Statement, and the interpretation of their movements under various circumstances:

Ratio of "loans" and "loans and investments" to bank resources.

Babson, 270-79.
Huebner: (above chapter).

Ratio of "cash" to "deposits" and to resources.

Babson, 280-88.
Huebner: (above chapter).

Interpretation of the showing of "surplus reserves" under various conditions.

Babson, 288-94.
Huebner: (above chapter).

Various Bank Statements—"summarized", "actual", "average" and "detailed"—described.

Huebner: (above chapter).

TOPIC XX

FACTORS AFFECTING THE PRICE AND VALUE OF SECURITIES (CONT.)

PANICS AND BUSINESS DEPRESSIONS INCLUDING AN EXPLANATION OF BAROMETRIC INDICES OF TRADE

The cause and psychology of panics and depressions.

Though secondary causes may contribute to make economic crises more severe, or to shorten or prolong their duration, the underlying cause is over-speculation and through this the over-extension of credit.

Jones, Chapter VIII, 153-79; Chapter IX, 180-217.

Periodicity of crises.

Jones, Chapter VII, 131-51.

Importance of the "factor of safety", with par-

ticular reference to the position of low-dividend or non-dividend stocks during periods of industrial or financial stress.

Gibson, "Cycles of Speculation," 114-17.

Barometric indices of trade — their significance, and the sources from which they are derived.

The aforementioned bibliography emphasizes the fact that, under modern credit systems, distinct cycles of trade occur at more or less irregular intervals, and, roughly speaking, each of these cycles contains a period of depression, a period of improvement, a period of prosperity and great speculation, and a period of decline, ending again with a period of depression. The approximate determination of which of the above-mentioned periods in the cycle the country is experiencing is necessarily a statistical one. For this purpose various groups of statistics (so-called "barometers" or "indices" of trade) are commonly consulted and periodically published in the leading financial journals. Whatever may be thought of the value of this data from the standpoint of forecasting future conditions (a matter which vitally affects stock market prices, since the stock market is essentially a discounting agency) there can be no question that a correct compilation of the data furnishes a fairly accurate view of the condition of trade for the time being, and furnishes the basis upon which se-

curity owners may exercise their judgment as to the future.

Babson, Chapter I.
James H. Brookmire, "Methods of Business Forecasting Based on Fundamental Statistics", pp. 43-58, American Economic Review, March, 1913, Vol. III, No. 1.
Melvin T. Copeland, Statistical Indices of Business Conditions, pp. 1-41. Quarterly Journal of Economics, Vol. XXIX, May, 1915.

TOPIC XXI

FACTORS AFFECTING THE PRICE AND VALUE OF SECURITIES (CONT.)

VARIOUS TYPES OF MANIPULATION

Fraudulent methods of manipulation.—(These have assumed three main forms, namely: (1) fraudulent management of properties and the issuance of fraudulent or deceptive reports and news items; (2) selling securities through improperly spread "tips" or "news"; and (3) "wash sales" and "matched orders".)

Pratt, 364-65, 386-87.

Manipulative campaigns planned with reference to future conditions, and involving skilful management in the art of accumulating or distributing lines of stock to the best advantage of the manipulator.

Pratt, 364, 365-68.
Bond, 77-85.

Corners.—(These have at times caused tremendous upheavals in the security market and become possible only because of the existence of a short interest in the market. A corner is brough about by an operator or pool obtain-

ing virtual possession of the shares available for delivery in fulfilment of short sales. Such sales are first induced on a large scale by apparently high prices or other methods, the short seller depending upon a continuous market for the purchase of stock for purposes of delivery. When the time to deliver arrives, the short interest finds that none is available, either for buying or borrowing purposes. The operator (or pool) has obtained possession of practically all the stock called for by the contracts made by the shorts. The only means of escape is to settle at a price determined by the operator, or to repudiate the contracts. While repudiation is permitted by law, such practice has not been countenanced by the rules of stock exchanges. In the case of various produce markets, however, rules have been adopted which provide that in case of a corner a reasonable settlement price can be established by a properly constituted committee, thus protecting the short interest against the arbitrary whim of the manipulator. Such rules, it is believed, will remove the incentive for operating a corner, since the decision of the committee will have in view the establishment of a fair settlement price.)

Pratt, 368-70, 387-88.

Illegality of corners.

Samuels vs. Oliver, 130 Ill. 73.

"Technical condition" of the market. (Reference is constantly made in the press to the

"over-bought" or "over-sold" condition of the market. By these terms it is meant that there has been, in view of the normal supply and demand of a given security, an unusually large amount of buying on margin or an unusually large amount of short selling. If this over-bought or over-sold condition is discovered, the opposing interest in the market may seek to compel a decline, or to compel the short interest to cover. Such a situation, known as the technical condition of the market, is rendered worse at times by the existence of (1) pyramiding and (2) an unusually large number of stop-loss orders.)

Bond, 68-76.

TOPIC XXII

FACTORS AFFECTING THE PRICE AND VALUE OF SECURITIES (CONT.)

INCREASING GOLD SUPPLY AND RAPIDLY RISING COMMODITY PRICES AND THEIR RELATION TO SECURITY PRICES

Causes producing rising commodity prices. With two main exceptions, the price factors, outlined in these topics, are either temporary in their operation or can only be considered in their relation to individual properties. These two exceptions are the intrinsic earning power of corporations and increasing commodity prices. These two basic causes affect security prices in general over long periods of time and without much regard to locality.)

Chamberlain, 492-512.
Gibson, 3-19, 73-94.

Effect on interest rates and on bonds, which, while possessing the advantage of certainty, have the disadvantage of a definitely limited income.

Chamberlain, 492-512.
Gibson, 15-16, 79-85.

Effect upon preferred stocks having a fixed rate of income.

Gibson, 79-85.

Effect upon the common stocks of railroads and most public service corporations.

Gibson, 17-19, 85-88.

Effect upon the stocks of industrial corporations.

Gibson, 88-89.

TOPIC XXIII

FACTORS AFFECTING THE PRICE AND VALUE OF SECURITIES (CONT.)

CROP PROSPECTS AND THEIR RELATION TO SECURITY PRICES

Of the numerous current happenings which have a vital bearing on security prices, few approximate in importance the annual condition of the nation's agricultural crops. The value of these crops aggregates annually between eight and nine billions of dollars. This huge mass of new wealth, besides furnishing directly a very large share of the high revenue producing tonnage of the nation's railroads, also vitally affects numerous other leading industries whose securities are listed on exchanges. While mining and forestry products are important, they are fairly regular and are subject to control in accordance with the demands of business requirements. The products of the soil, however, are mainly dependent on climatic conditions and their output is therefore uncertain to an unusual degree. The annual yield of leading staples, such as wheat,

corn and cotton, frequently vary from ten to thirty per cent. as compared with the preceding year. Fluctuations in these crops may also be much greater in one section of the country than another, thus vitally affecting corporations in those localities.

Intimate relationship between crop prospects and the movement of stock prices.

Gibson, "Elements of Speculation", 11-13, 35-43.

Government crop reporting system. (Were it not for some fairly accurate and unbiased system of crop reporting, first-hand information would be limited to a very few. The average person would be at the mercy of a flood of rumors and manipulation would exist on a scale infinitely greater than at present. For these reasons, as well as because of the fundamental importance of the subject from a business standpoint, it is highly important to have the Government issue reports periodically which represent about 95 per cent. of the acreage and 80 per cent. of the total of the nation's agricultural output):

Economic functions resulting from such reports.

Murray, 90, 99.

Sources of the data used, and method of preparing and disseminating the reports.

Murray, 91-94, 96-99.

Method of interpreting "condition" figures in order to arrive at the total yield.

Murray, 94-95.
Gibson, "Elements of Speculation", 17-19.

Private sources of current information on crop prospects.

Mudgett, 104, 119.

DIVISION IV

LEGAL PRINCIPLES GOVERNING THE STOCK EXCHANGE BUSINESS

TOPIC XXIV

LEGAL PRINCIPLES AND USAGES RELATING TO THE EXECUTION OF ORDERS AND THE CARRYING OF AN ACCOUNT

In addition to the principles enumerated in Topic X, the following duties of the broker in connection with the execution of orders and the carrying of accounts, deserve special study:

No secret profits may be made by the broker out of the transaction.

Dos Passos I, 218-19.

The customer must be given full notification of every transaction. This is also a statutory requirement at present.

Dos Passos I, 213-14.

Brokers are bound by the acts of their managers although there may be a violation of some private instruction unknown to the customer. *Dos Passos I, 214-18.*

Failure to carry out a definite order renders the broker liable for any consequent loss.

Dos Passos I, 206-08.

An order to purchase is not an entire contract, the broker being enabled to buy or sell a smaller quantity than is ordered. By usage, however, it is customary not to split into odd lots an order for the purchase or sale of a hundred shares or multiples thereof.

Dos Passos I, 208-10.

Proper accounts must be kept by a broker, showing the names of the persons with whom he deals for his customer; and failure to comply with this duty legally involves a presumption of value against him.

Dos Passos I, 218-19.

A broker is legally forbidden to buy his customer's stocks or to sell his own stocks to the customer, except by consent, i.e., he "cannot act as principal and agent in the same transaction without his customer's consent".

Dos Passos I, 365-82.

Usages in the stock brokerage business.

Dos Passos I, pp. 410-66.

The principal propositions, relative to the doctrine of usage in the stock brokerage business, as outlined by Dos Passos, are:

(1) "The usage of the business is never permitted to make an entire or new contract for the parties". The purpose of a usage is to supply deficiencies and omissions.

(2) The interpretation of technical words and phrases (and there are few businesses in

which peculiar terminology is so abundant) depends upon the usage of the business. The broker is protected if the usage, as understood by the trade, has been complied with. Written and express contracts, however, cannot be varied by usage.

(3) Usages cannot be opposed to fixed rules of law, may not be opposed to public policy, and may not be unreasonable. If, however, a usage does not conflict with the aforementioned three principles it is permissible as forming a part of the contract and is presumed to enter into the intention of the contracting parties.

(4) When employing a broker, a customer may presume that he has been employed with reference to "the customs of brokers". The stock broker, likewise, may presume implied authority to observe all the rules and usages of the exchange of which he is a member. The courts have gone so far as to read into the order, even if given in the form of a telegraphic message, the entire constitution and by-laws of the exchange of which the employed broker is a member.

(5) The usages of a particular brokerage firm may be introduced to interpret a contract when they are known to the party whom it is sought to charge with the same. But a broker cannot legally bind his client to such particular usages, which do not follow the ordinary and customary method, unless there is an express agreement covering the usage.

(6) The usual obligations of a broker may be changed and controlled by special agreements with his client, i.e., special contracts may be entered into, limiting the liability of the parties in any respect. Thus joint adventures in stocks (for speculation on joint account) may be entered into.

Dos Passos I, Chap. IV.

When a broker may close a transaction:

In the absence of an express agreement to the contrary, the broker may, upon reasonable notice, require his client to take securities carried for him and thus close the transaction. This principle is held by virtue of the fact that the client has a reciprocal right to close an account. Moreover, the courts hold that the commission is earned by making the transaction.

Dos Passos I, 385-86.

The client's securities may be sold in case of his bankruptcy, and it is the duty of the broker to take notice of the fact of bankruptcy.

Dos Passos I, 386-87.

The broker is justified in closing an account in case of the death of his client. In New York, however, the broker, if acting in good faith, may continue the account until the appointment of a legal representative.

Dos Passos I, 387-88.

Where demand for sufficient margin is not complied with, and where the right to sell without notice at either public or private sale has been reserved.

Markham vs. Jaudon, 41 N. Y. 235.

Brokers' communications are not privileged.

Dos Passos I, 400-04.

TOPIC XXV

RIGHTS AND DUTIES OF BROKER TO CLIENT AS (1) AGENT AND (2) PLEDGEE

Topic XI dealt with the principles governing client and broker in a speculative transaction as laid down by the widely known case of *Markham vs. Jaudon* (*41 N. Y. 235*). This case, however, is concerned only with the general basic principles governing pledgor and pledgee in speculative transactions and does not take cognizance of the numerous special problems that arise in such transactions. It is the purpose of this topic to present these special problems.

Degree of due care and diligence required of a broker when acting as agent or pledgee.

Dos Passos I, 218-41.
Isham vs. Post, 141 N. Y. 100.

Leading legal principles governing the disposition and safe-keeping of stock when purchased by a broker:

Liability in case of loss of the securities by theft, or otherwise.

Dos Passos I, 241-42.

Liability of remaining partners to a client whose securities are misapplied by one of the partners—liability for wrongful acts of clerks.

Dos Passos I, 243-44.

Rights of the broker with reference to the transfer of stock purchased for a customer on margin.

Dos Passos I, 241-46.

Extent of a broker's right to vote stock held by him for a customer's account.

Dos Passos I, 247-49.

Obligation of the broker at all times to have a sufficient quantity of stock under his control to deliver to his client upon payment of the amount due.

Dos Passos I, 252-64.

Rights of the broker with reference to dividends or assessments in connection with stock held by him as a pledge.

Dos Passos I, 264-75.

A broker's right to repledge stock en bloc.

There are four important New York cases which relate to the legal principles governing

this important subject, viz., *Douglas vs. Carpenter, 17 App. Div. 329 (1897); Rothschild vs. Allen, 90 App. Div. 233 (1904)*, affirmed 180 N. Y. 561; *Strickland vs. Magoun, 119 App. Div. 113 (1907);* and *Mayer vs. Monzo, 151 App. Div. 866 (1912)*. Of these cases the first and particularly the last are the most important, because they represent the previous and present law on the subject in New York. The courts of most other states have decreed that a broker may borrow money by sub-pledging margined stock en bloc. In New York, however, until the *Mayer vs. Monzo* decision, the ruling was otherwise, i.e., to the effect that a customer's margined stock could not be commingled with other securities by the broker and then pledged en bloc for a larger amount than the customer's indebtedness on the stock. Such commingling was held to constitute a conversion. This conclusion, as stated, was reversed in the important case of *Mayer vs. Monzo*. A study of this case is important not only because it presents the law of today but because the dissenting opinion reviews the facts and conclusions of all the preceding cases.

Mayer vs. Monzo, 151 App. Div. 866 (1912).

Liability of a broker when cooperating with an insolvent broker.

Austin vs. Hayden, 137 N. W. 317.

Measure of damages in case of error or conversion.

Dos Passos II, Chapter VIII, particularly pages 912-34.

Joint Adventures in Stocks.

Dos Passos I, 313-23.

TOPIC XXVI

EXTENT TO WHICH MARGINS AND PLEDGED SECURITIES OF CUSTOMERS ARE PROTECTED—PRINCIPLES GOVERNING THE IDENTIFICATION OF SECURITIES

The customer's right to pledged securities in case of the broker's insolvency:

Where a customer's stock is repledged by the pledgee, the customer (the owner) can recover from the sub-pledgee only after payment of the first pledgee's full debt.

McNeil vs. Tenth National Bank, 46 N. Y. 325.

A customer's stock, carried by a broker, goes to the customer and not the broker's assignee in case of insolvency.

Willard vs. White, 56 Hun 581.

Certain customers may have special claims over other customers because of special circumstances, such as payment of the full purchase

price to the broker for an outright purchase, or the misappropriation of a customer's securities by a broker and the placing of the proceeds of the unauthorized sale in his bank account. In the latter case the courts follow the doctrine of tracing trust funds.

In re Mulligan, 116 Fed. 715.
Garrard Glenn, "Rights of the Customers of an Insolvent Broker", Columbia Law Review, May, 1912, pp. 422-42.

If a broker mingles the stock of different owners and hypothecates the same en bloc, some rightfully and some wrongfully, customers whose stock is wrongfully hypothecated have a superior equity and are entitled to have prior payment of their losses, provided their stock or its proceeds can be traced.

Matter of Mills, 125 App. Div. 730.

Identification of Securities. (The application of the aforementioned principles depends upon the ability of owners of securities to properly identify the same, thus frequently giving rise to numerous questions as to the marshalling of securities or proceeds between the customers.)

Dos Passos I, 285-93.

BOOKS REFERRED TO IN THE OUTLINE OF A COURSE ON STOCK EXCHANGE BUSINESS

ADAMS—*Stocks and Their Features—Division and Classification.* By John Adams, Jr., 1910, pp. 43–62. Published in the Volume on "Stocks and the Stock Market", Annals of the American Academy of Political and Social Science, Philadelphia, $1.50.

BABSON—*Factors Affecting Commodity Prices.* By Roger W. Babson, 1911. Published in the Volume on "American Produce Exchange Markets", Annals of the American Academy of Political and Social Science, Philadelphia, $1.50.

———*Business Barometers for Anticipating Conditions.* By Roger W. Babson, 1917. Tenth Edition. Wellesley Hills, Mass. Babson Statistical Organization, $2.00.

BOND—*Stock Prices: Factors in Their Rise and Fall.* By Frederick D. Bond, 1911. Moody's Magazine Book Department, New York, $1.00.

BROOKMIRE—*Methods of Business Forecasting Based on Fundamental Statistics.* By James H. Brookmire, 1913. American Economic Review, Vol. III, No. 1, pp. 43–58.

BURGUNDER—*The Declaration and Yield of Stockholders' Rights.* By B. B. Burgunder, 1910. Published in the Volume on "Stocks and the Stock Market," Annals of the American Academy of Political and Social Science, Philadelphia, $1.50.

CHAMBERLAIN—*The Principles of Bond Investment.* By Lawrence Chamberlain, 1911. Henry Holt & Co., New York, $5.00 net.

Constitution of the New York Stock Exchange.

COPELAND—*Statistical Indices of Business Conditions.* By Melvin T. Copeland, 1915, Quarterly Journal of Economics, Vol. XXIX, May, 1915, pp. 1–41.

DOS PASSOS—*A Treatise on the Law of Stock Brokers and Stock Exchanges.* By John R. Dos Passos, 1905. The Banks Law Publishing Co., New York, two volumes, $12.00.

EMERY—*Speculation on the Stock and Produce Exchanges of the United States.* By Henry C. Emery, 1904. The Macmillan Co., New York, $2.00; paper $1.50.

GIBSON—*The Elements of Speculation.* By Thomas Gibson, 1913. Gibson Publishing Co., New York, $1.00.

———*The Increasing Gold Supply.* By Thomas Gibson, Editor, 1908. Gibson Publishing Co., New York.

———*The Cycles of Speculation.* By Thomas Gibson, 1907. The Moody Corporation, New York, $1.50.

GLENN—*Rights of the Customers of an Insolvent Broker.* By Garrard Glenn, 1912. Columbia Law Review, May, 1912, pp. 422–42.

GOLDMAN—*A Handbook of Stock Exchange Laws.* By Samuel P. Goldman, 1914. Doubleday, Page & Co., New York.

Hearings before the Senate Committee on Banking and Currency on S. 3895, 63d Congress, Second Session. 1914. Government Printing Office, Washington.

HIGGINS—*The Put-and-Call.* By Leonard R. Higgins, 1906. London, Effingham Wilson, Royal Exchange.

HUEBNER—*The Scope and Functions of the Stock Market.* By S. S. Huebner, 1910. Published in the Volume on "Stocks and the Stock Market", Annals of the American Academy of Political and Social Science, Philadelphia, $1.50.

———"*The Stock Market,*" a text now in course of preparation.

———(Also see "*Stocks and the Stock Market*".)

JONES—*Economic Crises.* By Edward D. Jones, 1900. The Macmillan Co., New York.

KOCH—*German Imperial Banking Laws, together with the German Stock Exchange Regulations.* 1910. Edited by R. Koch. Government Printing Office, Washington. Published by the National Monetary Commission, 61st Congress, 2d Session, Sen. Doc. No. 574.

LYON—*Corporation Finance.* By Hastings Lyon. Complete Edition, 1916. Houghton Mifflin Co., New York. Vols. I and II bound together, $3.00.

MITCHELL—*Stockholders' Profits from Privileged Subscriptions.* By Thomas Warner Mitchell,

1905. The Quarterly Journal of Economics, Cambridge, Mass., Volume XIX, Feb., 1905, pp. 231–269.

MOODY—*How to Analyze Railroad Reports.* By John Moody, 1912. Analyses Publishing Co., New York.

MUDGETT—*Current Sources of Information in Produce Markets.* By Bruce D. Mudgett, 1911. Published in the Volume on "American Produce Exchange Markets", Annals of the American Academy of Political and Social Science, Philadelphia, $1.50.

MURRAY—*The Crop Reporting System.* By Nat C. Murray, 1911. Published in the Volume on "American Produce Exchange Markets", Annals of the American Academy of Political and Social Science, Philadelphia, $1.50.

NELSON—*The A. B. C. of Options and Arbitrage.* By S. A. Nelson, 1904. New York, 75c.

NORTON—*The Purchase or Sale of Securities through a Stock Broker.* By Eliot Norton, 1910. Published in the Volume on "Stocks and the Stock Market", Annals of the American Academy of Political and Social Science, Philadelphia, $1.50.

———*Short Sales of Securities through a Stock Broker.* By Eliot Norton, 1907.

PRATT—*The Work of Wall Street.* By Sereno S. Pratt, 1914. D. Appleton & Co., New York, $2.00.

ROLLINS—*Convertible Bonds and Stocks.* By Montgomery Rollins, 1910. Published in the Volume on "Stocks and the Stock Market",

Annals of the American Academy of Political and Social Science, May, 1910, pp. 97–110, Philadelphia, $1.50.

———*Convertible Securities.* By Montgomery Rollins, 1913. Second Edition. Financial Publishing Co., Boston, $5.00 net. (The introductory Chapter to which page references refer may be obtained separately for 50c. per set.)

Stocks and the Stock Market. Edited by S. S. Huebner, 1910. Annals of the American Academy of Political and Social Science, Philadelphia, $1.50.

Todman—*Brokerage Accounts.* By Frederick S. Todman, 1916. Ronald Press Co., New York, $3.50.

Van Antwerp—*The Stock Exchange from Within.* By Wm. C. Van Antwerp, 1914. Doubleday, Page & Co., New York.

Vidal—*The History and Methods of the Paris Bourse.* By E. Vidal, 1910. Government Printing Office, Washington. Published by the National Monetary Commission, 61st Cong., 2d Session, S. Doc. No. 573.

Withers—*Stocks and Shares.* By Hartley Withers, 1910. E. P. Dutton & Co., New York, $2.00.